

Unleashing India's Growth: Challenges and Opportunities



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EVEREST CAPITAL

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COVER PHOTOS: Indian software engineers; Taj Mahal; Teacher in a rural Indian school

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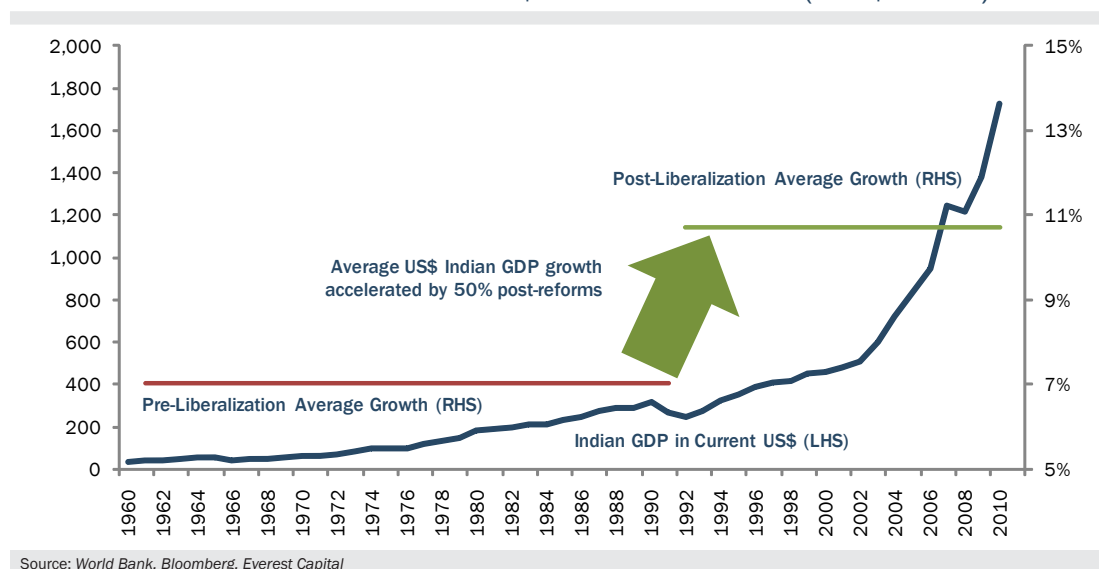
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Executive Summary

Investors have closely watched India's economic trajectory since its economic reforms in the 1990s. But the narrative of what is in store for India continues to evolve. A year ago, economists were predicting that India's economy would expand rapidly in the coming years—many said it could grow even faster than China's. For example, an influential Morgan Stanley report predicted that India's young labor force, high savings rate, and strong services sector would enable India to outpace China's rate of growth within three to five years, reaching annual real GDP growth of 9 to 10 percent.¹

Exhibit 1: Indian GDP in Current US\$ Pre- and Post-Reforms (in US\$ Millions)



Today, however, such predictions seem to have been premature. Following a decade of expansion, India's economy grew at its slowest pace in two years from July to September 2011, and economists are forecasting a continued slowdown in the near future.² Over the past year, India watchers have turned increasingly pessimistic about its growth prospects and place much of the blame on India's government for not coming through with needed reforms.

Instead of engaging in the debate, this report starts from the premise that India offers tremendous opportunities and looks forward—focusing on the most effective things India can do to unleash the next wave of economic growth.

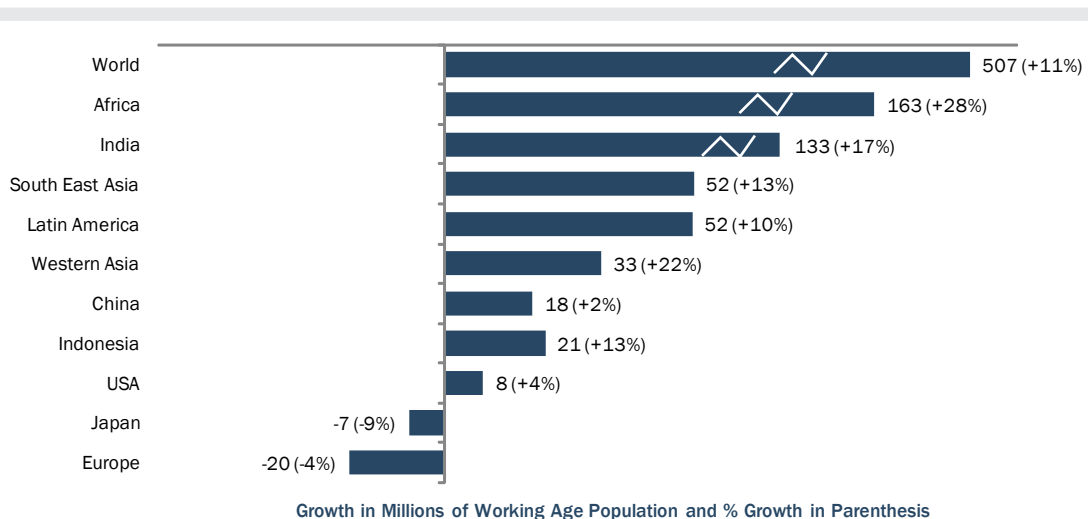
Longstanding obstacles to doing business in India such as red tape, poor protection of intellectual property rights, and differences across India's states have acted as a brake on economic expansion.

In addition, India's government has so far failed to deliver on many of the pro-business reforms it promised when the Congress-led government was reelected by a landslide in 2009. The session of Parliament that ended in December 2011 was notable mostly because the government backtracked on a meaningful reform that would have allowed foreign direct investment in multi-brand retail and would have opened up a \$450 billion sector to companies such as Walmart. Parliamentary lethargy, the fall-out from recent corruption scandals, and the Congress party's need to cater to its base of largely agricultural, indigent voters have each slowed down pro-business reforms.

While foreign companies investing in India would welcome all of the pro-business reforms that are already on the government's agenda (as discussed below), two areas of reform—infrastructure and education—will give India the biggest economic boost.

India's inadequate transportation infrastructure and problems providing electricity currently shave approximately two percentage points off its annual GDP growth. The government plans to spend \$1 trillion on infrastructure over the next five years, 50 percent of which is expected to come from the private sector. But further reforms to encourage and facilitate private sector investment are also necessary, as this report highlights.

Exhibit 2: Increase in Working Age Population, 2020 versus 2010 (in millions)



Source: UN, Morgan Stanley Research

Second, India has one of the largest and youngest pools of labor in the world. This could provide an enormous boost for economic expansion, as young Indians enter the labor force and the age dependency ratio (the number of children and elderly per 100 people of working age) becomes more favorable. But the country will only be able to reap the significant economic benefits of this demographic dividend if it adequately trains its citizens for twenty-first century jobs.

Everest Capital believes there may be a good opportunity in Indian equity and debt markets as macroeconomic conditions remain solid and growth has the potential to accelerate should the stalled reforms, as discussed elsewhere in this report, begin to move forward. A compelling valuation case and growth outlook is central to the potential equity market opportunity, and attractive yields and greater foreign participation due to the dismantling of investment restrictions could underpin the debt market opportunity.

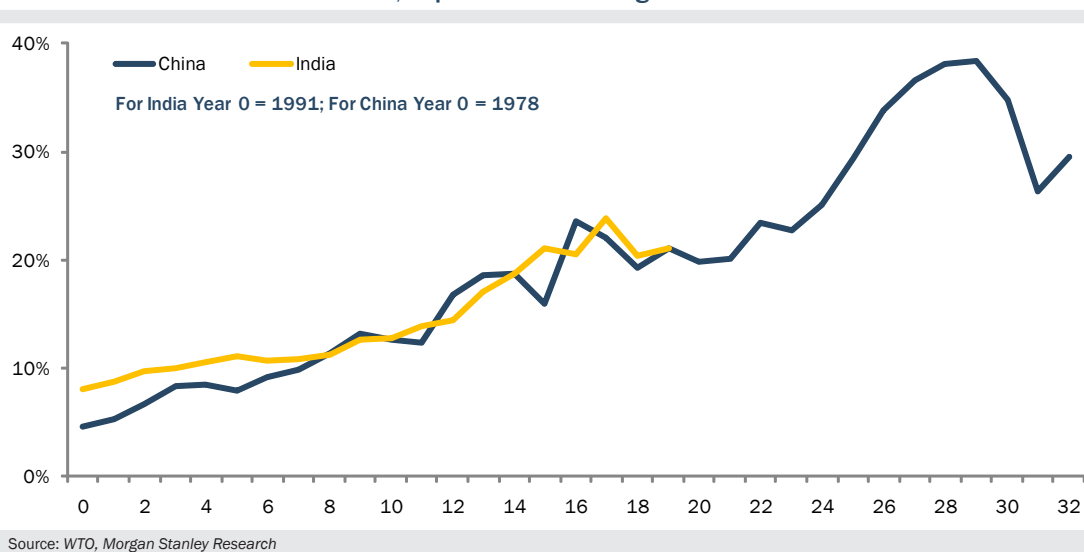
The country's next national elections will be held in 2014. In the meantime, positive signs such as further broadening of the infrastructure investor base and increased numbers of workers receiving vocational training will signal that Prime Minister Manmohan Singh, the man who led India's first round of liberalization, is unleashing the next wave of growth.

Start and Stop

India Opens Up

India's liberalization began in 1991 after decades of state-controlled economic planning when Prime Minister Narasimha Rao and then-Finance Minister Manmohan Singh devalued the rupee, slashed import duties from 47 to 29 percent on average, and for the first time encouraged foreign direct investment (FDI) in the Indian economy.³ The country's growth rate and exports instantly jumped following these reforms, and India's information technology revolution took off.

Exhibit 3: India Versus China, Exports as Percentage of GDP Since Start of Reforms



Whither Reform?

Since 2004, the Indian National Congress (Congress) Party has led a United Progressive Alliance (UPA) coalition government with Singh as prime minister. When Congress and the UPA were reelected by a landslide in 2009, India-watchers had high hopes that momentum behind the reforms—which seemed to have stalled—would speed up. Prime Minister Singh spoke of “a massive mandate” in a victory speech following his party's re-election.⁴ Pro-business advocates such as the Confederation of Indian Industry quickly called for fast tracking reforms such as increasing investments in infrastructure; updating labor laws so that employers could hire and fire workers more easily; removing continued restrictions on

foreign investment; and streamlining licensing requirements.

But reforms have stalled and growth is slowing. Phrases such as “wobble in confidence”⁵ and “inflection point”⁶ increasingly describe investors’ attitudes toward India. Industry analysts forecast a relatively disappointing (by Indian standards) 7.2 percent growth rate for 2012 downgraded from earlier projections of 7.7.⁷

The Root of the Problem

What is to blame for India’s reduced performance over the past year and more modest forecast? Longstanding obstacles to operating businesses in India are part of the problem. India’s red tape problem is pervasive and will not be removed overnight. For example, companies must obtain approximately 70 approvals to operate in India (unless in a special economic zone). In the World Bank’s “ease of doing business” index, India ranks 132: lower than the West Bank and Gaza, and just ahead of Nigeria.⁸

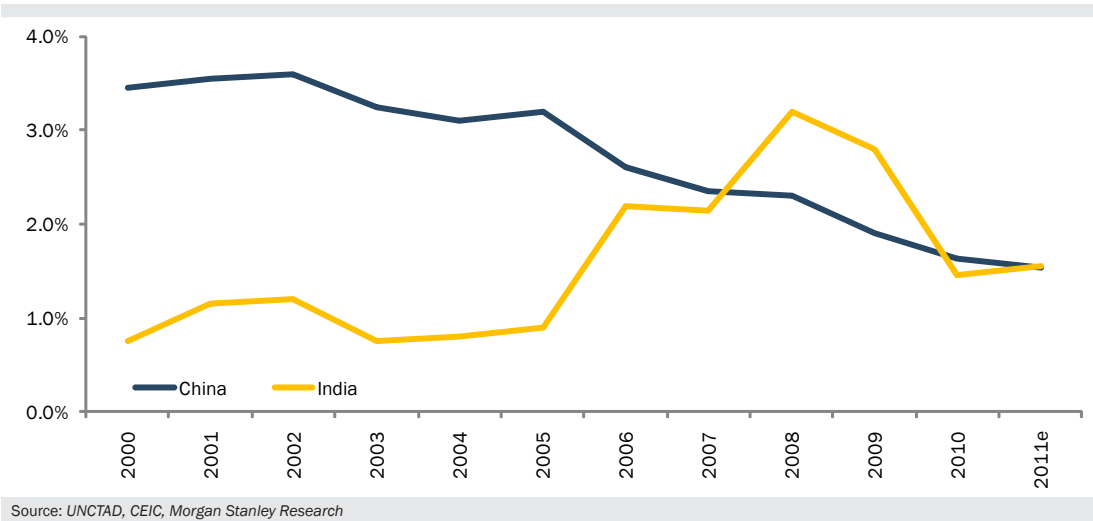
Additionally, India is one of 11 countries on the Office of the U.S. Trade Representative’s “priority watch list” for violating intellectual property (IP) rights. Poor enforcement of IP rights is a significant disincentive to businesses looking to expand in new markets.

Finally, India has 35 states and union territories with many differences in regulation. A member of the American Chamber of Commerce said recently, “Doing business in different [Indian] states is like doing business in 30 different countries.”⁹

The government’s announcement of a number of reforms and subsequent failure to implement them has also contributed to creating uncertainty for businesses planning an expansion into or within India.

There are some bright spots: since 2009, India has made progress in external sector reforms such as trade by signing (or nearly completing) a number of important trade agreements (see Exhibit 5). In addition, the country has continued to push ahead with capital account reforms such as allowing foreigners to invest directly in Indian mutual funds and raising the ceiling for investments by foreign institutional investors in corporate infrastructure bonds from \$5 billion to \$25 billion.

Additional progress is needed in other areas. For example, FDI in many sectors remains closed or severely restricted. Although last summer a government committee approved allowing FDI in multi-brand retail, the government was forced to shelve its reform plans due to strong opposition in parliament’s winter session. Prime Minister Singh has said his government will reintroduce the retail decision this spring after he has had more time to build consensus.¹⁰ Further, legislation to modernize India’s 50-year-old tax code has been on parliament’s agenda since 2010,¹¹ as has an important goods and services tax bill since

Exhibit 4: India versus China, FDI Inflows (as a Percentage of GDP)

last spring. Even less promising are the prospects for reform to India's labor laws, which are confusing and redundant. (India has more than 40 federal and 100 state labor laws, some of which contradict each other.) The status of reforms by sector are noted in detail in Exhibit 5. Minimal progress was made on the reform agenda in the parliamentary session that ended in December 2011.

Exhibit 5: Progress and Delay on Key Reforms by Sector Since 2009**External sector reforms**

Trade reforms:

- In August 2009, India signed a free trade agreement for goods with the Association of Southeast Asian Nations to open a \$1.1 trillion market to Indian exports. A much-awaited follow up services agreement is under negotiation. Further, India and the EU are in the final stages of negotiating a free trade agreement to slash duties on more than 90 percent of trade and open markets for services and investment.¹²

Capital account reforms

FDI reforms:

- India allows FDI of 49 percent in Indian air carriers, but does not allow foreign airlines to invest directly or indirectly in domestic carriers. Reportedly, the government will soon approve a change that will allow foreign airlines to invest.¹³
- FDI in satellite and cable TV broadcasting is capped at 49 percent. The Ministry of Information and Broadcasting favors increasing this limit to 74 percent.
- India permits 100 percent FDI in cash and carry and wholesale trading and 100 percent in single-brand stores.¹⁴ FDI in multi-brand retail is pending.¹⁵
- The government is considering increasing permitted FDI in the insurance sector from 26 to 49 percent.¹⁶

Portfolio investments:

- The government decided in 2011 to allow foreign retail investors to invest directly in Indian mutual funds.¹⁷ Further, the government raised the ceiling for foreign institutional investments in corporate infrastructure bonds from \$5 billion to \$25 billion.¹⁸

Internal sector reforms

Labor sector reforms:

- India is known for its redundant and restrictive labor laws. The Industrial Disputes Act, for example, stipulates that firms employing more than 100 workers must have government permission to fire employees. Labor Secretary Prahat Chaturvedi has signaled that the government is serious about reforms in this sector, but it is unclear whether a labor working group's proposals—such as raising the Industrial Disputes Act's threshold from 100 to 300 workers—will see progress.¹⁹

Tax structure:

- A finance committee ran out of time to introduce direct tax code legislation in parliament's winter session.²⁰ The proposed bill would modernize India's 50-year-old tax code by ending unnecessary exceptions and streamlining tax rates and administration for foreign investors—and would raise revenue.
- Finance Minister Pranab Mukherjee introduced a Goods and Services Tax bill in March 2011 to replace excise duties, service taxes, and value added taxes and create a single Indian common market. Differences between states worried about loss of revenue and the national government have stalled the bill.

Why Has Reform Stalled?

Parliamentary lethargy, the fall-out from recent corruption scandals, and the Congress party's need to cater to its base, which includes many agricultural, indigent voters, has slowed down pro-business reforms.

Although parliament is considering bills that cover reforms in a number of areas, its slowness to act puts the future of several key pieces of legislation in doubt. As of the end of the winter session of parliament, 96 bills were pending, many of them having languished for years.²¹ "Policy lethargy and complacency," as a commentator recently put it, in part explains slow progress in the reform agenda.²² Consensus among the parties in India's large coalition government is often elusive, and leadership from above is sometimes wanting.

Two recent major corruption scandals have generated a huge public outcry and paralyzed the national government. First, the chief organizer of New Delhi's 2010 Commonwealth Games sporting event resigned shortly after the games and was arrested in April 2011 on charges that he had conspired to inflate costs when procuring equipment for the games at a loss of some \$20 million to the government.²³ Even worse was the fall-out from the government's 2008 sale of broadband licenses at below-market prices—some of them to firms with no previous experience in the telecom sector in return for bribes—at a cost to the government of \$39 billion (roughly the size of India's defense budget).²⁴ The Communications and Information Technology minister resigned in November 2010, was subsequently arrested on charges of conspiracy and cheating, and is awaiting trial.²⁵ This scandal may be the largest graft case in India's history.

The country has seen a huge public response. Last spring and summer, social activist Anna Hazare attracted hundreds of thousands of supporters when he pledged to fast until the government strengthened its anti-corruption laws and created an independent agency to review corruption complaints.²⁶ Parliament is now further debating a proposed bill (see Exhibit 6).²⁷ Although Prime Minister Singh has not himself been accused of wrongdoing, critics have faulted him for not being a more hands on manager of his party and its senior officials.²⁸

These scandals and protests have somewhat paralyzed the Congress-led government due to time expended on disruptions from the opposition when parliament was in session and by lowering public confidence in the party.

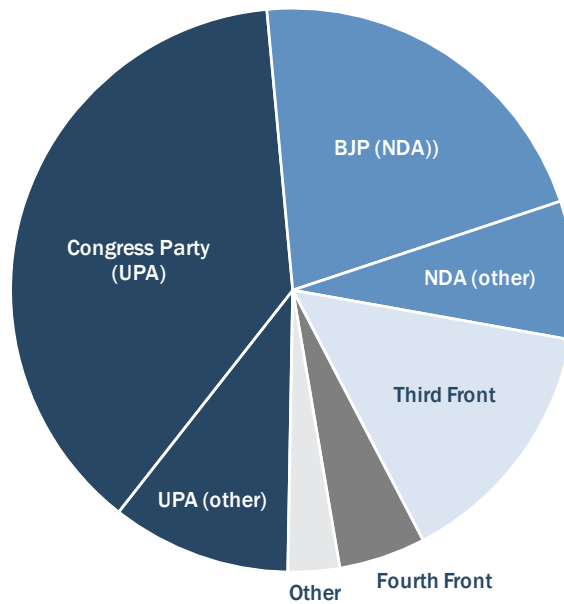
Exhibit 6: Anna Hazare's Anti-Corruption Protests

In April 2011, a social activist named Anna Hazare pledged to fast until the government strengthened its anti-corruption laws and urged the creation of a Lokpal (“ombudsman”) and an independent agency to review corruption complaints.²⁹ Hazare attracted thousands of followers across India and ended his weeklong fast when the government said it would create a committee made up of government officials and activists to draft Lokpal legislation.

But two bills emerged from the committee: a government version and a version produced by civil society members (called the Jan Lokpal bill).³⁰ And when the cabinet approved the government’s draft bill in July, “Team Anna” (as Hazare and his advisors are known) was not happy with the bill’s provisions. Hazare began a second fast in August that attracted hundreds of thousands of supporters—many of them middle class professionals and college students, groups that have in the past been considered politically apathetic.

The summer’s standoff ended when parliament adopted a nonbinding resolution endorsing Hazare’s key demands and parliament set up a committee to further debate the proposed bill.³¹ Parliament’s winter session was extended by three days to discuss the issue. However, the session ended before both houses of parliament had voted on the relevant legislation.³²

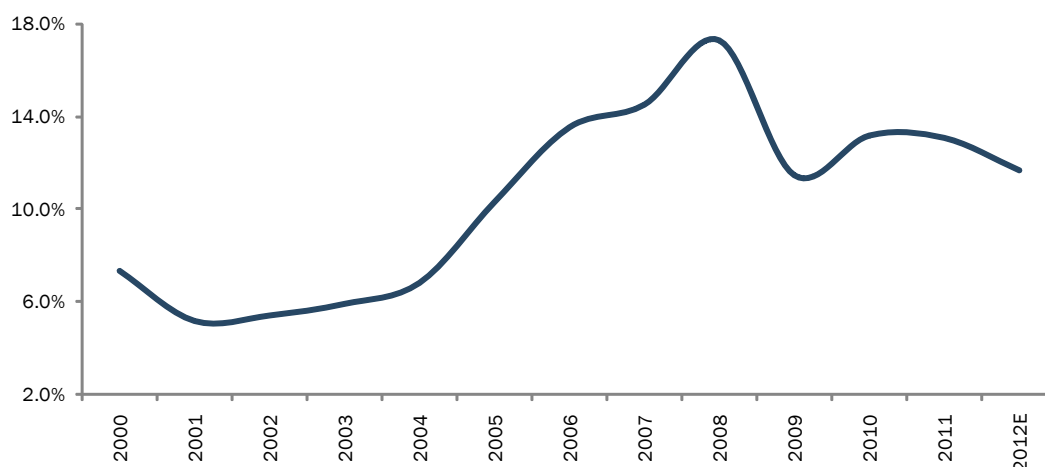
Exhibit 7: Breakdown of Parliament by Alliances and Major Political Parties



Source: Election Commission of India, Everest Capital

Finally, electoral politics can complicate the possibilities for pro-business reforms. Congress's voting base is predominantly made up of farmers and the rural poor. Much debate recently ensued over the government's introduction of a land acquisition bill to increase compensation to villagers dislocated by industrial projects. The bill could prove pivotal to the party's support from rural voters in upcoming elections.³³ But the legislation may not be good for investors, who would face increased costs to acquire land.³⁴ Demonstrations by farmers often delay projects. Plans for a South Korean company to build a \$12 billion steel plant in Odisha³⁵ have been under discussion since 2005 and are presently stalled due to farmers protesting at the proposed site of the plant.³⁶ Similarly, Tata Motors had to stop work in its Nano car factory in West Bengal in 2008 due to violent protests.³⁷

Exhibit 8: Indian Private Corporate Capex (as Percentage of GDP)



Source: CEIC, CSO, Morgan Stanley Research

Corruption scandals and poor policy-making have, in part, accounted for the inability of private corporate investment to return to pre-financial crisis levels. (See Exhibit 8). In contrast to its response to the sharp economic slowdown in 2008-09, the government needs to push private investments to revive growth. However, a high fiscal deficit and stubbornly high inflation limit the government's ability to use fiscal and monetary policy to spur private sector-led economic growth. In order to boost growth in the aftermath of the global financial crisis, the government introduced the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), which boosted rural wages without increasing productive capacity, resulting in higher and sticky inflation. The ensuing inflation has also had the effect of limiting the government's ability to loosen monetary policy during the current economic slowdown.

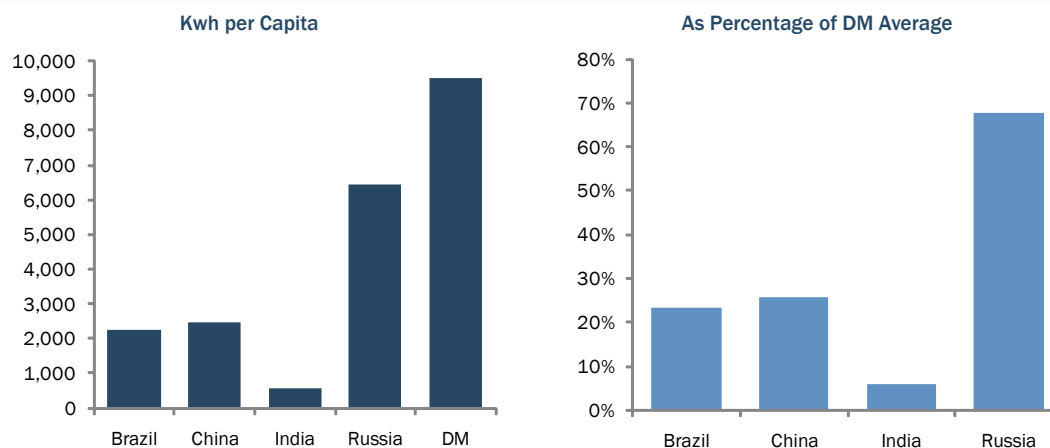
Unleashing the Next Wave of Growth

Despite such inertia and challenges, India can unleash significant additional growth by making key reforms in only two sectors: infrastructure and education.

The Utility of Utilities

As anyone who travels to both China and India knows, India needs better roads, highways, bridges, and airports to accelerate economic growth. Structurally inadequate and poorly maintained roads lead to congestion that delays commuters and slows transportation of goods. (For example, recent food price inflation is due in part to shortages caused by storage and transportation challenges.)

Exhibit 9: BRICs Electricity Consumption Versus Developed Markets (DM)



Source: World Bank/PPIAF, GS Global ECS Research

India also needs to address problems of limited access to electricity and reliability of supply, particularly during peak hours. As many as 56 percent of Indian rural households do not have access to electricity.³⁶ And even in India's largest cities, companies depend heavily on inefficient (and heavily subsidized) diesel backup generators. As a recent World Bank report finds, electricity access is the top constraint to doing business for medium-size urban firms in India.³⁹

Government subsidies to ensure that electricity prices are kept low for the poor contribute to the supply problem (see Exhibit 10). Poor connections between transmission networks across regions also hinder the movement of power from states with a surplus of electricity to those in need. The absence of a single authority responsible for the power sector (regulators operate at both the state and federal levels) further complicates electricity provision.⁴⁰

Exhibit 10: India's Electricity Subsidies Problem

Government subsidies to ensure that electricity prices are kept low for the poor contribute to the country's supply problem. Electricity subsidies to farmers alone cost the Indian government around \$6 billion a year, leaving state electricity boards losing money and preventing the government from connecting additional households. (State governments have been accused of offering electricity for irrigation pumps to farmers for free in states such as Maharashtra and Punjab in order to win votes.)⁴¹ National Planning Commission Deputy Chairman Montek Singh Ahluwalia recently observed that the poor are not even benefiting from most electricity subsidies (presumably because they have such limited access to electricity) and has proposed alternative policies such as cash transfers to ensure the affordability of electricity for the poor.⁴²

Improving infrastructure is crucial both to maintaining current growth levels and increasing future growth. For example, the World Bank reports that India needs to invest three to four percent more of its GDP in infrastructure just to sustain current levels of growth.⁴³ And economists estimate that poor infrastructure shaves as much as two percentage points off India's growth.⁴⁴ More specifically, McKinsey & Company has found that poor roads, railroads, water, and air transportation contribute to losses of four percent of GDP per year, which will increase to more than five percent by 2020 in the absence of improvements to the transportation system.⁴⁵ McKinsey proposes that by building higher density long-distance transportation corridors; developing "logistics parks" to maximize the efficient use of road and rail networks; improving the efficiency of existing assets (e.g. by increasing the numbers of electronic tolls); allocating proportionately more to railways compared to roads; and investing several hundred billion more in transportation infrastructure, losses would be reduced by half in 2020.⁴⁶ With additional infrastructure investment, India's GDP could surpass 10 percent annual growth.

Government Proposals to Build Infrastructure

India's government recognizes that it needs to expand electricity generating capacity, access, and transmission. Thirty-two percent of infrastructure spending under the eleventh (current 2007-2012) Five Year Plan (a policy document created every five years by a planning commission chaired by the prime minister)⁴⁷ has been devoted to electricity, which

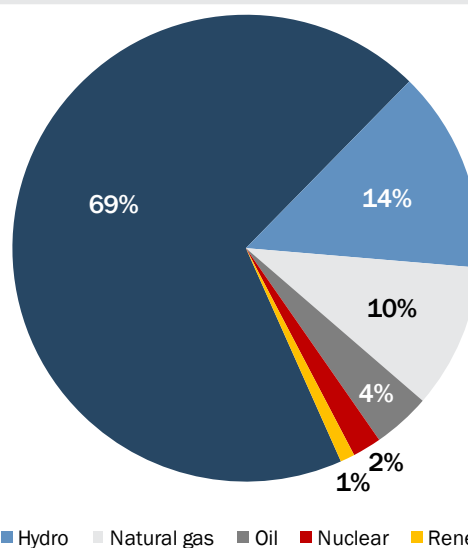
represents the largest share of infrastructure spending (see Exhibit 11). And India's forthcoming twelfth Five Year Plan calls for 100,000 megawatts of total added energy capacity from 2012 to 2017, mostly by expanding coal, hydro, and nuclear power.⁴⁸ Exhibit 12 breaks down India's current electricity mix. This ambitious goal would increase generating capacity by nearly 55 percent from current levels.

Exhibit 11: Planned Infrastructure Spending 2007 to 2012⁴⁶

	\$ Billions	As a % of Total
Electricity	\$166.6	32%
Roads & Bridges	\$78.5	15%
Telecommunications	\$64.6	13%
Railways	\$65.5	13%
Irrigation	\$63.3	12%
Water Supply/Sanitation	\$35.9	7%
Ports	\$22.0	4%
Airports	\$7.7	1%
Storage	\$5.6	1%
Oil & Gas Pipelines	\$4.2	1%
Total	\$514.0	

Source: Planning Commission, Government of India, 2006-07 prices.
(Dollar amounts are based on Rs. 40 per \$1 exchange rate. Numbers do not add up due to rounding.)

Exhibit 12: Electricity Generation Mix as of 2011



Source: "India's Energy Policy and Electricity Production," interview with Charles Ebinger, National Bureau of Asian Research, October 2011, p. 1.

Financing Investments in Infrastructure

It is not clear whether the government will be able to finance the needed investments. The most recent financial year budget included a funding increase of 23.3 percent for the infrastructure sector over the previous year, for a total of \$47 billion.⁴⁹ The current Five Year Plan provides for \$500 billion total in infrastructure spending. The government's goal for the upcoming Five Year Plan is to double this: spending a whopping \$1 trillion on infrastructure.⁵⁰

But the government has regularly missed its infrastructure targets. And Deputy Chairman of India's Planning Commission Montek Singh Ahluwalia says the government will miss current five-year infrastructure targets by 10 to 12 percent.⁵¹ Even this figure is optimistic, since it includes the enormous recent spending on the telecommunications sector, not on the hard infrastructure and electricity that is in the most dire shape.⁵²

The government acknowledges that increased investment from the private sector is a must if it wants to meet its ambitious goal for the next five years.⁵³ Fifty percent of the planned \$1 trillion spending on infrastructure is expected to come from the private sector (up from 30 percent of the planned \$514 billion under the current five year plan).⁵⁴

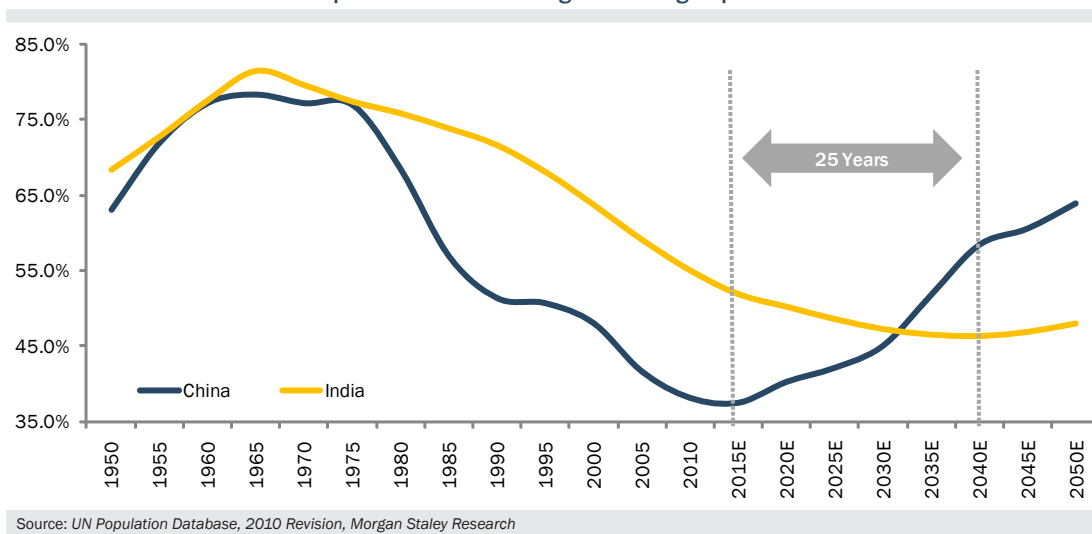
Toward this end, last year the government allowed four Indian infrastructure firms to issue tax-free bonds worth \$6.7 billion.⁵⁵ As noted in Exhibit 5 above, the government also relaxed restrictions on foreign institutional investors, raising the cap on investments in Indian infrastructure bonds from \$5 billion to \$25 billion.⁵⁶ (When this move did not generate substantial investment due to concerns about the strings attached to the bonds, the government changed the required lock-up period from three years to one year and allowed investors to choose infrastructure bonds with a range of maturities instead of limiting their choices to bonds with a residual maturity of five years.)⁵⁷ The government particularly wants to increase investment from private equity funds and has introduced financial tools such as credit enhancements to reduce risk through partial guarantees.⁵⁸

However, many companies remain unsure about risks and returns on investment given India's high inflation.⁵⁹ Further reforms such as allowing insurance and pension companies to invest directly in infrastructure projects—as is the case in many other parts of the world—would help. Poor implementation of projects, including delays and cost overruns, also holds up investment. Better project management would increase returns on investment and thus make the investment more attractive.

India's "Demographic Dividend"

India's booming population is also crucial to growth and contributes to India's positive growth story. Nearly 400 million Indians were under age 15 in 2010, and by 2030, India is expected to account for a fifth of the global workforce.⁶⁰ (See Exhibit 2) More importantly, the United Nations estimates that India's age dependency ratio (the number of children and elderly per 100 working people ages 15 to 64) will improve from 55 in 2010 to 49 in 2025, meaning increasingly more Indians whose earnings and savings can fuel consumption and growth.⁶¹ By comparison, China's age dependency ratio is relatively low now but is projected to worsen as a generation of only children increasingly supports the country's aging population.⁶² (See Exhibit 13) These trends have led many scholars to celebrate India's "demographic dividend" and account for much of the optimism that it will surpass China's rate of growth in the coming years. India will have increasingly more workers to drive the economy and provide for children and the elderly. Scholars have calculated that India's changing age structure and a modest demographic dividend have already contributed to growth in recent decades and anticipate that the country's increasing demographic dividend could add around two percent per year to per capita income growth.⁶³

Exhibit 13: India: Favorable Demographics
Proportion of Non-Working to Working Population



Education Today, Growth Tomorrow

But while an expanding workforce can fuel growth, it also poses a challenge. India will reap the benefits of this demographic dividend only if it can educate its citizens with training and knowledge to succeed in twenty-first century jobs.

Exhibit 14: Population Pyramids of India and China, in 2010, 2030, and 2050



Source: World Population Prospects (UN, 2009).

As with infrastructure, India's government clearly recognizes the problem. Prime Minister Singh has often referred to the current Five Year Plan as an "education plan" and has underscored the importance of investing in his country's human resources.⁶⁴ And the government has in recent years achieved notable progress in areas such as primary education. The Ministry of Human Resource Development, led since 2009 by the talented Kapil Sibal, has been particularly active in pushing reforms.

However, further areas for improvement remain. India needs to do more to enforce and enhance access to universal primary education; expand and improve the quality of secondary education; increase opportunities for vocational training and skills development; and strengthen higher education so that Indian colleges and universities can compete globally.

Progress on Primary Education

India has made progress on ensuring universal access to primary education. Its Right to Education (RTE) Act came into force April 1, 2010⁶⁵ and guarantees free and compulsory education for children from six to 14 years old, some eight million of whom were not in school as of 2009.⁶⁶ The Act further mandates that private schools reserve 25 percent of places for low-income, underprivileged, and disabled students, which means children from the poorest neighborhoods are now attending some of India's most prestigious private schools.⁶⁷ (See Exhibit 15 for more on equal access to education.) The reform was widely praised by international observers such as the United Nations, which called it "ground breaking."⁶⁸

Exhibit 15: Ensuring Equal Access to Education

Despite progress in enrolling more girls in school, outcomes differ across regions. In 2010, 5.9 percent of girls age 11 to 14 were out of school, down from 6.8 percent in 2009. However, this obscures differences across states such as Rajasthan (12.1 percent) and Uttar Pradesh (9.7 percent) on the one hand, where the percentage remains high, and states such as Bihar on the other hand, where the percentage of both boys and girls out of school has been in decline since 2005. (Four point four percent of boys and 4.6 percent of girls age 11 to 14 in the state were out of school in 2010).⁶⁹ The government's continued focus on inclusive growth in recent plans demonstrates awareness of the distance still to go.

Yet India continues to face chronic problems of teacher absenteeism, accountability, and shortages. The government wants to address the first two challenges by decentralizing teacher recruitment and increasing community involvement in school management. As to finding teachers to fill vacancies, schools across the country need a sobering *one million* additional teachers to meet RTE standards.⁷⁰

The government also hopes to increase enrollment in secondary schools, which is currently around 60 percent.⁷¹ But perhaps more importantly, the government has identified a need to better support secondary school students who drop out of secondary school or do not pursue university degrees with some jobs training.

Higher Education and Global Competitiveness

Although the Indian economy is expected to continue creating jobs, the country may not have enough skilled employees to fill them. There is a shortage in both the quantity of study places available to students and the quality of the education those who obtain the scarce coveted spots receive.

First, quantity. The government wants to increase the percentage of the workforce that has acquired formal skills through vocational training from 12 to 25 percent over the next five years. This means training *70 million* people,⁷² equal to the current population of Thailand!

At the university level, parliament has recently taken positive steps toward establishing more than 1,000 new institutes of higher education, including eight prestigious Indian Institutes of Technology (IITs).⁷³ Further, Minister Sibal has also pledged to expand enrollment in university education from around 12 percent to 30 percent within ten years to bring India more in line with general higher education enrollment rates in the developed world.⁷⁴

Additionally, the government is increasingly focusing on quality as well as quantity and addressing problems of unemployable college graduates, teacher shortages (which plague the higher education sector as well as primary schools), and limited government funding. For example, although India's engineering schools have 1.5 million students, an Indian information technology industry association found that only 25 percent of them are employable in "high-growth global industries" such as information technology and call centers.⁷⁵ According to media reports, hundreds of Indian companies regularly retrain workers who have higher education but who learned from an outdated curriculum and inadequate equipment.⁷⁶ The call-center company 24/7 Customer Pvt. Ltd. hires three out of every 100 Indian applicants and now recruits in the Philippines and Nicaragua due to the poor qualifications of Indian would-be employees.⁷⁷ Large companies such as Tata and Wipro run their own training institutes to get new recruits up to speed.

The government is taking some bold and controversial steps to ensure investment in its colleges and universities. In a preliminary draft of the upcoming Twelfth Five Year Plan for 2012 to 2017, the government has underscored privatization in the education sector.⁷⁸ A divisive bill to allow foreign educational institutions to set up campuses and offer degrees in India is also pending in parliament due in part to concerns that foreign schools would be

driven by profit motives.⁷⁹

India is very focused on improving education outcomes for its citizens. However, there are areas in which the government needs to do more to fully reap the benefits of its enviable demographic dividend. The government has not yet met its eleventh Five Year Plan target of spending six percent of GDP on education.⁸⁰ (The 11.3 percent of its total government spending dedicated to education in 2010-2011 is close to the standards of more developed economies, however.)⁸¹ Observers should also pay attention to progress made on increasing enrollment rates and implementing the ambitious national vocational qualification framework Minister Sibal recently launched to help prepare the tens of millions in need of skills.

Long-Term Market Opportunity

Everest Capital believes that the long-term outlook for Indian equity and debt markets has the potential to be among the best when compared to other developing countries. The opportunity for both markets is based on several overlapping factors that could create attractive U.S. dollar returns and, as explained above, include: highly favorable demographic trends over the next several decades; the potential to further fuel economic growth from the introduction of market friendly reforms; and improvements in infrastructure and education. In addition, a compelling long-term potential valuation and growth case will help equity markets, while the debt market opportunity is bolstered by a favorable relative valuation and ownership structure.

Macroeconomic Fundamentals

The outlook for macroeconomic fundamentals, and particularly the outlook for the Indian rupee, remains supportive of attractive long-term U.S. dollar denominated market returns. A rebound in private investment from, in part, greater foreign direct investment (FDI) and portfolio inflows could offset the current account deficit, which has been averaging above 2.5 percent of GDP since 2008. Portfolio flows have been dominated mainly by equity flows historically, although fixed income flows could increase as restrictions for direct investment in the local debt markets are eased.

The higher current account deficit reflects, in part, a worsening terms of trade over much of the last decade. “Terms of trade” is a measure of the relative prices of exports versus imports. A worsening terms of trade reflects higher prices paid for imports and lower prices received for exports, which negatively impacts the balance of trade assuming no changes in volumes imported and exported. The worsening terms of trade is partly the result of higher energy prices as India imports approximately 30 percent of its energy needs.⁸² A recent Goldman Sachs report estimated that the country’s current account balance declines by 0.5 percent of GDP for every \$10 per barrel increase in the price of oil.⁸³

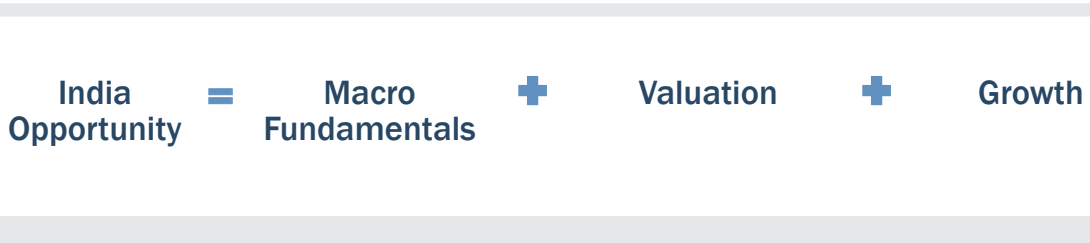
Despite the short-term challenges facing the currency, the weakening against the U.S. dollar that occurred during the latter half of 2011 has left the rupee at a sharply more attractive valuation on a real effective exchange rate (REER) basis, and toward the middle of the range in terms of the country’s 10-year average. As stated in this report, addressing corruption scandals, moving forward with the stalled reform agenda, and increasing fixed income portfolio flows and investments in infrastructure and education could be support-

ive for the currency as it would generate greater investment opportunities and accelerate potential economic growth over the long term.

Equity Market Opportunity

In addition to supportive macroeconomic fundamentals (particularly foreign currency outlook), the factors that Everest Capital monitors to determine the attractiveness of a country's equity market reveal a compelling long-term opportunity for Indian equities. These additional factors include valuation, growth of earnings, and growth of dividends.

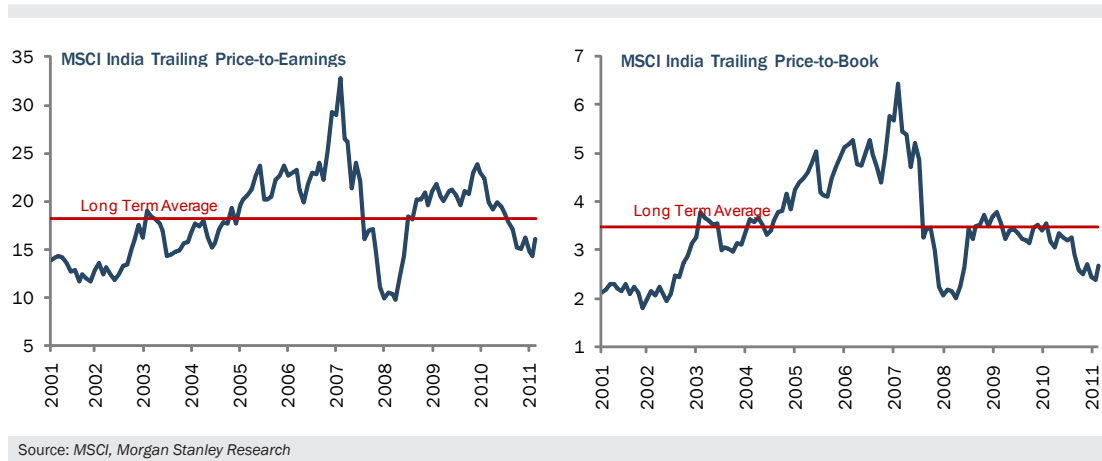
Exhibit 16: Components of U.S. Dollar Equity Market Returns



Valuation

Long-term equity market returns for the Indian market are currently supported by attractive valuations relative to historical averages. The MSCI India Index currently trades at a discount of 20 percent and 30 percent versus its 10-year average trailing price-to-earnings and price-to-book multiples, suggesting an attractive long-term entry point. (See Exhibit 17)

Exhibit 17: MSCI India Trailing Price-to-Earnings and Trailing Price-to-Book Multiples



Growth

Long-term earnings growth is driven by nominal GDP growth, evidenced by the fact that the two have posted a compounded annual growth rate of 15 percent and 16 percent respectively over the last eight years. Nominal GDP growth has averaged over 14 percent in the 20 years since liberalization and has the potential to accelerate further given demographic trends, passage of market-friendly reforms, and improvements in infrastructure and education. The opportunity for faster GDP growth was stated earlier in this report as McKinsey & Company found that poor infrastructure alone contributes to losses of four percent of GDP per year.

Earnings and dividend growth are the key drivers of the long-term investment opportunity for Indian equities. Everest Capital looks at the combined financial statements of a representative sample of publicly-traded non-financial Indian companies in order to analyze the market as if it were one large company and call this “company” India, Inc. It has a market cap of over \$180 billion, annual sales of almost \$160 billion, and net income of over \$13 billion. India, Inc. has posted an estimated five-year compounded annual growth rate (CAGR) through 2011 of nearly 20 percent, coupled with a strong balance sheet that includes a leverage ratio of only 1.0 time and an interest coverage ratio of 8.9 times. (See Exhibit 18)

Exhibit 18: India, Inc. Balance Sheet and Income Statement Highlights

	Trailing 5-Year Growth
Net Sales	+22.6%
EBITDA	+17.1%
Net Income	+19.3%
Leverage Ratio*	1.0x
Interest Coverage**	8.9x

* Calculated as Net Debt/EBITDA

** Calculated as EBITDA/Interest Expense

Source: UBS

Given a solid balance sheet and strong growth profile, market returns have also been supported by double-digit growth of dividends of over 13 percent during the period, and a dividend yield that has averaged 1.7 percent over the last five years.

Fixed Income Market Opportunity

The potential long-term opportunity for the local fixed income market in India is based on

our view that the market is relatively liquid and under-owned and offers one of the highest government treasury yields in the emerging market universe.

India boasts one of the largest local debt markets in the emerging market universe, roughly the size of the Brazilian debt market. The Indian treasury market totals approximately \$500 billion according to J.P. Morgan estimates, equal to nearly 30 percent of GDP. Regulatory changes dismantling foreign ownership restrictions should introduce fresh liquidity into this large market opportunity.

The Indian fixed income market is under-owned. India's portfolio flows have been historically dominated by equity flows given restrictions on direct investment in the local debt markets, particularly the treasury and corporate bond market. Foreign ownership in the Indian treasury market is estimated at a low of 2 percent versus estimates of over 30 percent in Asian peers like Indonesia and Malaysia.⁸⁴

India currently has one of the highest local treasury yields relative to other emerging market countries at 8.5 percent,⁸⁵ which should support fixed income portfolio inflows from foreigners looking to capture the higher carry. Portfolio inflows should benefit from an easing of restrictions on direct investment in the local treasury and corporate debt market by foreigners.

Political Road Map into 2014

Whether the government continues to facilitate infrastructure investments and education reforms will depend in part on the outcome of the country's next national elections, which will be held in 2014. Important elections in states such as Uttar Pradesh (whose population is roughly the same as that of Brazil, the world's fifth most populous country) are scheduled before then.⁸⁶ Congress's UPA coalition won three of five state elections held in April and May of 2011, so it is quite possible that the coalition will dominate the national political scene for the next several years.⁸⁷ However, Prime Minister Singh is 79 years old and probably would not serve another term.⁸⁸ Thus, speculation has begun about who could initiate a new wave of reforms should the Congress party remain in power.

The 41-year old Rahul Gandhi is considered by many the inevitable Congress candidate for prime minister and has the support of top Congress ministers.⁸⁹ Rahul is the son of current Congress party president Sonia Gandhi and heir to the so-called Nehru-Gandhi dynasty in Indian politics. Rahul is said to be advised by a circle close to his mother that favors populist policies and may not strongly advocate for further liberalization (see Exhibit 19).⁹⁰

Other possible Congress candidates include Home Minister Palaniappan Chidambaram, Finance Minister Pranab Mukherjee, and Defense Minister A.K. Antony.⁹¹ Of the three, Mukherjee is most likely to push through a reform agenda. Chidambaram has a good record on this score having advocated for reforms to ensure growth.⁹² But as finance minister, Mukherjee has done the most to introduce bills crucial to reform, and along with Prime Minister Singh, was a strong backer of the bill to open up the retail sector to FDI that recently caused the government such angst. (Antony on the other hand was reportedly one of the Congress ministers concerned about the impact of the bill on mom and pop stores.)⁹³

Exhibit 19: Rahul Gandhi and the Nehru-Gandhi Dynasty

Rahul Gandhi is the son of current Congress party president Sonia Gandhi and former prime minister Rajiv Gandhi, the grandson of India's iron lady and long-serving prime minister Indira Gandhi, and the great-grandson of India's founding father and first prime minister Jawaharlal Nehru.

Rahul entered politics (winning a seat in parliament) in 2004 having largely stayed out of the spotlight before then. His supporters have cast him as a "youthful rejuvenator," and he has focused on youth drives, outreach to rural voters, and reviving the Congress party in the heartland states of the north.⁹⁴ Rahul is currently the party's general secretary, and when his mother Sonia Gandhi was in the United States for surgery this past August, Rahul was one of four Congress members selected to oversee party affairs during her absence.⁹⁵ The government has not disclosed what ails Sonia Gandhi, but there is speculation in the press that she is seriously ill and doubt about whether she will be able to continue to lead her party. If Sonia becomes incapacitated or dies this will seriously disrupt Indian politics. Her passing could increase the likelihood that the public will turn to her son.

But Rahul's mettle as a leader has yet to be proved. He has a reputation for gaffes and has limited political accomplishments under his belt. Many observers continue to consider him a neophyte and will be closely watching him campaign in state elections with his sister Priyanka this year.⁹⁶ (Priyanka is considered by some to be a replacement candidate as she is seen to be the more dynamic and poised of the two. However, she has said she is focused on raising her children.)⁹⁷

The Hindu-nationalist Bharatiya Janata Party (BJP) is India's largest opposition party, and there are signs that the party has evolved to be a more formidable competitor leading up to the 2014 election. The party wants to brand itself as focused on development and good governance and distance itself from appeals to Hindu nationalist sentiment.⁹⁸ Possible BJP candidates for prime minister include: Lal Kishanchand Advani the former deputy prime minister;⁹⁹ Narendra Modi, the controversial chief minister of Gujarat who has presided over impressive development and attracted sizable investment in his state but has also been accused of complicity in deadly anti-Muslim riots in the state in 2002;¹⁰⁰ former cabinet minister and leader of the opposition in the Rajya Sabha Arun Jaitley; and Sushma Swaraj, the leader of the opposition in the Lok Sabha.¹⁰¹

Regional and caste-based parties will probably also play a role in shaping the outcome in 2014 and influencing the next government's policy agenda.¹⁰² Analysts argue that the influence of these smaller parties has already been seen in Congress's increasing attention to rural issues and the relationship between state and national government.¹⁰³

Conclusion

India's prospects for renewed growth will be greatly strengthened if the country's government and people can come together behind the reforms covered above. Investors should not only pay careful attention to how much spending the government allocates to infrastructure but should also watch for signs that the government is attracting investment into the bond markets and moving forward on infrastructure reforms such as further broadening of the infrastructure investor base.

Investors should also be mindful that India will not fully reap the advantages of its demographic dividend if it does not improve the quality of education. India's government needs to address issues such as teacher absenteeism, accountability, and shortages and equip students with up-to-date skills training and opportunities to enter globally competitive universities. Positive signs in this sector would be increased numbers of workers receiving vocational training and increased enrollment in Indian secondary schools and universities.

The long-term outlook for Indian equity and debt markets is positive and, in part, underpinned by the successful passage and implementation of the current government's reform agenda and investment program. The investment outlook is further supported by several factors expanded upon above, including: attractive valuations; high economic growth; strong corporate and macroeconomic fundamentals; and continued easing of foreign investment restrictions in debt markets.

In the meantime, the world will be closely watching Prime Minister Singh, the man who led India's first round of liberalization, and hoping that he can propel his country once again to unprecedented growth.

Abbreviations

BJP	Bharatiya Janata Party
Congress	Indian National Congress Party
DMK	Dravida Munnettra Kazhagan
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IIT	Indian Institutes of Technology
IP	Intellectual Property
RTE	Right To Education Act
UNESCO	United Nations Educational, Scientific and Cultural Organization
UPA	United Progressive Alliance

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